Transferring Closely Held Company Equity

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To a Key Employee—Part I of II

The author encourages, as a starting point, owners of a closely held company to consider numerous issues with regard to the compensation of key employees. If the closely held company operations are successful, valuable and long-term employees sometimes seek to be compensated through an equity ownership in the company. This key employee desire for equity ownership has practical implications as well as taxation implications. From the practical perspective, the founding owners assumed the business risks and financial risks of starting the closely held company. Accordingly, the founding owners understandably feel that they are entitled to their equity ownership. On the other hand, the key employee may be directly responsible for much of the company's recent success.

Introduction

The owners of a closely held company often must consider numerous issues with regard to the compensation of key employees. If the closely held company operations are successful, valuable and long-term employees sometimes seek to be compensated through an equity ownership in the company. This key employee desire for equity ownership has practical implications as well as taxation implications. From the practical perspective, the founding owners assumed the business risks and financial risks of starting the closely held company.

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This discussion considers some of the options that are available to the closely held company owners who want to provide equity (or quasi-equity) ownership to a key employee. This discussion focuses on a simple hypothetical example fact set. This illustrative example assumes that the subject employee provides a truly valuable contribution to the closely held company. And, this discussion assumes that the current company owners are willing to consider all options with regard to transferring an equity interest to the key employee.

Each of the equity transfer alternatives considered in this discussion have advantages and disadvantages. In any actual equity transfer situation, both the current company owners and the key employee should consider all of the risks and costs of each equity transfer alternative. This discussion presents one equity transfer solution that is appropriate for the hypothetical individuals in the illustrative fact set. However, alternative equity transfer structures may be more appropriate in other circumstances.

In all cases, the closely held company owners and the key employee would benefit from the professional advice of legal counsel, income tax advisors, and business valuation specialists.

Illustrative Fact Set

Let's assume that Fred Founder formed Alpha Architectural Associates (Alpha) as a limited liability company (LLC) in 2000. Fred has been the sole member of the LLC since its formation. Alpha elected to be taxed as an S corporation in 2006, and it has maintained that income tax status ever since.

Coincidentally, Ed Employee also joined Alpha in 2006. So, Ed has been with Fred for about 12 years, or about two-thirds of the life of the Alpha architectural firm. However, not only is Ed a long-term employee, he is also a key employee. Fred readily admits that Ed has been essential to the success and growth of Alpha over the last decade or so. And, Ed readily admits that Fred has been fair (if not generous) with regard to his base salary and annual bonus.

Nonetheless, like many key employees, Ed is not satisfied with a salary and bonus alone. Ed wants some form of equity ownership interest in Alpha. Alpha does not have either an employment agreement or a noncompete agreement with Ed. Because losing Ed would be a substantial risk to the Alpha competitive advantage as a successful professional services firm, Fred agrees to consider the available options regarding an equity transfer to Ed.

Important Considerations—Both to the Company and to the Key Employee

The decision to offer an equity ownership interest or a quasi-equity compensation vehicle requires careful consideration of both the income tax consequences and the business consequences. Some of the practical considerations (to both the closely held company and the key employee) include the following:

1. How important is the key employee to the closely held company's success? Does the key employee possess any unique skills that would be difficult for the closely held company owners to replace?
2. Does this situation affect any of the company ownership succession planning that is already in place? Is this key employee capable of completing a future purchase of the entire company? Will the key employee's presence as part of this company increase its future value and/or make it easier to find a potential future buyer at ownership transaction time?
3. Will this key employee make a good business partner to the company's current equity owners? Does this employee work well with the company's current owners? Or, are there any future personality conflicts that may be foreseeable?
4. How does the current ownership group feel about giving up some portion of control of the closely held company? Would a new perspective—from a new owner—invigorate the closely held company?
5. What is the key employee's position (or ability) regarding the payment of income taxes on the value of the equity ownership transfer? Is the income tax impact of an equity transfer a potential "deal breaker" for the key employee?

After considering the above-mentioned factors, the current company owners and the key employee typically enter negotiations regarding what percentage (or what dollar amount) of equity will be transferred to the employee. That process typically starts with a business valuation of the total equity of the closely held company.

There are various generally accepted standards of value and premises of value that could be applied in this business valuation process. The term standard of value is pretty much synonymous with the term definition of value, and it basically answers the question of: value to who? The term premise of value describes the transactional circumstances under which the hypothetical (or actual) company sale will take place. The premise of value basically answers the question: how would the company be sold if it was actually put up for sale?

There are generally accepted business valuation approaches that are typically applied in the closely held company business valuation. There may be numerous individual business valuation methods that may be applicable to the closely held company valuation. However, all of these individual methods are typically categorized into three general business valuation approaches. These three generally accepted business valuation approaches are typically called the Income Approach, the Market Approach, and the Asset-based Approach.

Typically, the employer company will engage a professional valuation specialist to (1) develop the business valuation analysis and (2) prepare a written report of the valuation analysis and the value conclusion. The employer company may retain the valuation analyst because such an analyst has specialized training, credentials, and expertise. The employer company may also retain such a valuation specialist simply because the analyst is independent. That is, the analyst's value opinion should be unbiased and objective. To ensure this objectivity, the employer company and the key employee often agree to somehow share the expense of the business valuation. That way, the valuation specialist recognizes, as clients, both the company and the employee.

When the closely held company total equity value is concluded, the next step in the process is to determine what percentage (or what dollar amount) of the company equity will be transferred to the key employee. This part of the process should be separate from (although it is practically related to) the issue of how the equity interest will be transferred to the employee. That is, the next question in the process is: how much of an equity ownership interest will the key employee end up with? After that decision is made, the following question is: how will the equity be granted, sold, or otherwise transferred to the key employee?

There are two general categories of procedures that are often used to quantify how much equity should be transferred to the key employee:

1. A contributory valuation analysis
2. A direct negotiation

In the contributory valuation analysis, the independent valuation analyst is asked to quantify—and recommend to both parties—the equity allocation to the key employee. There are generally accepted value allocation methods that the valuation specialist can apply, including:

1. the before and after method,
2. the with and without method, and
3. the personal goodwill valuation method.

In the first method, the analyst quantifies (1) the company equity value before the key employee joined the organization, (2) the current date company equity value, and (3) the amount of the equity appreciation that should be attributed to the key employee's efforts (versus to other value creation factors). In the second method, the analyst quantifies (1) the current date actual company equity value, (2) the current date hypothetical company equity value as if the key employee did not work for the subject company, and (3) the difference in the two business value estimates. In the third method, the analyst attempts to directly quantify the amount of the business goodwill personally created by the key employee. In this method, the analyst may consider the following factors to the extent they can be directly associated with the key employee: incremental contracts signed, incremental revenue generated, decremental expenses incurred, decremental investment expenditures made, decremental company risk (through reduced costs of capital or otherwise), and similar factors.

Obviously, each of the above contributory valuation analyses involve the specialist's professional judgment and the subjective selection of valuation variables. For this equity allocation process to be successful, the valuation specialist has to be accepted by all parties as being independent and objective. While there is professional judgment involved in this equity allocation procedure, the valuation specialist can ensure that there is a consistency in the fundamental variables applied in both (1) the overall company business valuation and (2) the contributory valuation analysis. That is, the valuation analyst can ensure that the equity allocation is based on a consistent (or at least reconcilable) measurement of: income tax rates, present value discount rates, direct capitalization rates, profit margins, expected long-term growth rates, valuation pricing multiples, valuation discounts and premiums, and so on.

The direct negotiation procedure is the alternative to the contributory valuation analysis procedure. In this procedure, the parties (the closely held company and the key employee)—or their representatives—get together and directly negotiate the amount (percentage or dollar value) of the company equity to be transferred to the employee. If the two parties can truly negotiate amicably, then this procedure can be effective and efficient. Often, even if both parties enter the negotiations amicably and in good faith, such negotiations result in controversy—or at least personal bad feelings. Accordingly, the party representatives—such as legal counsel or accountants—are often involved in the more contentious aspects of the negotiation.

So, if the current company owners and the key employee can amicably negotiate to achieve a common goal, then the direct negotiation process can be successful. Alternatively, if each party is negotiating to achieve their maximum self-interests, reliance on the third-party independence of the contributory valuation analysis may be the most effective path to concluding how much equity to transfer to the key employee.

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